

ORIGINAL



MEMORANDUM

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TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division
DATE: January 30, 2007

EA for EGJ

RE: STAFF REPORT FOR LEVEL 3 COMMUNICATIONS, LLC APPLICATION FOR A LIMITED WAIVER OF THE PUBLIC UTILITY HOLDING COMPANIES AND AFFILIATED INTERESTS RULES (A.A.C. R14-2-801 ET SEQ.) AND ENCUMBRANCE OF ASSETS. (DOCKET NO. T-03654A-06-0689)

Attached is the Staff Report for the application of Level 3 Communications, LLC for a limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules and Encumbrance of Assets. Staff recommends conditional approval.

EGJ:AII:tdp

Originator: Alexander Ibhadie Igwe

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Docket No. T-03654A-06-0689

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

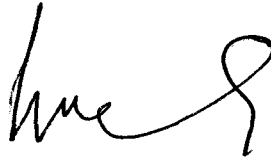
**LEVEL 3 COMMUNICATIONS, LLC
DOCKET NO. T-03654A-06-0689**

**APPLICATION FOR A LIMITED WAIVER OF THE PUBLIC UTILITY HOLDING
COMPANIES AND AFFILIATED INTERESTS RULES AND ENCUMBRANCE OF
ASSETS**

JANUARY 30, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for Level 3 Communications, LLC (Docket No. T-03654A-06-0689) was the responsibility of the Staff member listed below. Alexander Ihade Igwe was responsible for the financial review and analysis of this application.

A handwritten signature in black ink, appearing to read 'Ihade Igwe', followed by a long, sweeping horizontal line extending to the right.

Alexander Ihade Igwe
Executive Consultant III

EXECUTIVE SUMMARY
LEVEL 3 COMMUNICATIONS, LLC
DOCKET NO. T-03654A-06-0689

On October 25, 2006, Level 3 Communications, LLC, ("Level 3 Arizona" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission") for a limited waiver of the Public Utility Holding Companies and Affiliated Interests rules and encumbrance of assets. Level 3 Arizona is a Delaware limited liability company certificated by the Commission to provide facilities-based and resale local exchange, toll and access services pursuant to Decision No. 61737 dated June 4, 1999. Level 3 Arizona is a wholly owned subsidiary of Level 3 Financing, Inc. ("Issuer"), which in turn, is wholly owned by Level 3 Communications, Inc. ("Parent").

Level 3 Arizona seeks Commission authorization for a limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules, Arizona Administrative Code ("A.A.C.") R12-2-801 to R12-2-806 (the "Rules"), in connection with certain financing arrangements, or in the alternative, Commission approval to issue guarantees and pledge its Arizona assets as security for the proposed notes. The filing indicates that Level 3 Financing, Inc. will issue a series of notes to qualified institutional buyers in an offering that is exempt from registration, under the U.S. Federal securities laws. Level 3 Arizona projects aggregate offerings of approximately \$1.5 billion. The First Series Offering will consist of \$600 million 9.25% fixed rate senior notes due in 2014. On December 19, 2006, the Applicant filed a supplemental application indicating that a Second Series Offering, consisting of \$650 million in fixed rate notes will be issued under the same terms and conditions as the First Series Offering. The loan proceeds will be used for general business purposes, debt reduction and potential acquisition activities, other than its pending acquisition of Broadwing Corporation. The Applicant claims that issuance of the notes will provide it with greater access to financial resources, enhance its ability to provide competitive services and increase the breadth and scope of telecommunication services in Arizona. Level 3 Arizona states that its proposal to issue guarantees and pledge assets will not impair its day-to-day operations or change its management.

Level 3 is a class A utility, and thus, subject to the Rules, intended to (a) prevent commingling of utility and non-utility funds; (b) prohibit cross-subsidization on non-utility activities by utility ratepayers; (c) prevent negative impact on non-utility activities on a utility's financial credit; and (d) ensure that the utility and its affiliates provide Commission with the information necessary to "carry out its regulatory responsibilities". The Applicant contends that it would be unreasonably costly and burdensome to comply with the Rules for the proposed financing arrangements.

Staff's analysis indicates that the Applicant's request for a limited waiver from the Rules may not fully protect the ratepayers in Arizona. Further, Staff finds that the Applicant's request for authorization to issue guarantees and pledge Arizona assets as security for the Notes should not impair the availability of service to consumers since the Applicant provides competitive services that are available from alternate service providers. Also, Staff finds that Applicant's pledge of Arizona assets should not impair its financial status, further hinder its ability to attract

capital at fair and reasonable terms or inhibit its ability to provide safe, reasonable and adequate service. However, customers may still have exposure to losses to the extent they have prepaid for service or made deposits. Accordingly, any authorization for encumbrances should provide customer protection for prepayments and deposits.

Staff recommends approval for Level 3 Arizona to issue guarantees and pledge Arizona assets or to provide other forms of security for the applied for borrowings up to \$1.5 billion, subject to the condition that all Arizona customer deposits and prepayments, if any, be secured by a bond or an irrevocable sight draft letter of credit which is not included in the pledged collateral.

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Introduction

On October 25, 2006, Level 3 Communications, LLC ("Level 3 Arizona" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission") requesting a limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules ("Rules"), in connection certain debt financing or in the alternative, Commission authorization to guarantee and to the extent necessary, encumber its assets to secure the proposed debt.

Public Notice

Notice of the financing application was published in the *Arizona Republic* on November 30, 2006. A copy of the notice is attached.

Background

Level 3 Arizona is a Delaware limited liability company certificated by the Arizona Corporation Commission to provide facilities-based and resale local exchange, toll and access services pursuant to Decision No. 61737 dated June 4, 1999. Level 3 Arizona is a wholly owned subsidiary of Level 3 Financing, Inc. ("Issuer"), which in turn is wholly owned by Level 3 Communications, Inc. ("Parent").

The Applicant states that based on its operating revenues in Arizona, it is a Class A utility. As a result, it is subject to the Commission's Public Utility Companies and Affiliated Interests Rules, which seeks to (a) prevent commingling of utility and non-utility funds; (b) prohibit cross-subsidization on non-utility activities by utility ratepayers; (c) prevent negative impact on non-utility activities on a utility's financial credit; and (d) ensure that the utility and its affiliates provide Commission with the information necessary to "carry out its regulatory responsibilities".

The Transaction

Level 3 Arizona seeks Commission limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules, in connection with certain proposed financing arrangements or in the alternative, Commission approval to issue guarantees and pledge its Arizona assets as security for Level 3 Financing, Inc.'s proposed debt financing.

Level 3 Financing, Inc proposes to issue approximately \$1.5 billion in notes with similar terms and conditions to qualified institutional buyers ("Buyers") in a series of offerings. The first proposed offering consists of \$600 million (the "First Series Offering") 9.25% fixed rate senior notes due in 2014. On December 19, 2006, the Applicant filed a supplemental application indicating that the second offering will consist of \$650 million fixed rate senior notes (the "Second Series Offering"), with the same terms as the First Series Offering. The Applicant states that the loan proceeds will be used for general business purposes, debt reduction and potential acquisition activities. For example, proceeds of the Second Series Offering will be

utilized to buy back older notes that were issued at a higher interest rate of 10.75%. Level 3 Arizona contends that its participation in the financing arrangement as a guarantor will not impact its management or operations in Arizona.

Level 3 Arizona's request for a limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules is predicated on Commission Decision No. 64737. The Applicant contends that in Decision No. 64737, the Commission determined that only when a transaction "could directly or indirectly result or cause an increase in its maximum rate on file with the Commission for any competitive service" would a company have to make necessary filings under the rule. Level 3 Arizona states that it primarily provides competitive wholesale services to other carriers, Voice over Internet Protocol ("VoIP") providers and Internet Service Providers ("ISP"). As a result, the Applicant concludes that it has neither the ability nor the incentive to unilaterally charge high or above market rates that could be used to fund or subsidize unregulated affiliates, or to commingle utility and non-utility funds in a manner detrimental to Arizona ratepayers. Level 3 Arizona claims that it does not anticipate that the proposed financing arrangement will cause an increase in its maximum rates on file with the Commission for competitive services since it provides competitive wholesale services.

Level 3 Arizona states that its request for Commission authorization to participate in the proposed financing arrangement serves the public interest. The Applicant claims that the proposed financing arrangement promotes competition by providing it with access to greater financial resources. Also, it enhances its ability to effectively compete with other carriers in bringing competitive telecommunication services to ratepayers in Arizona.

Financial Analysis

The Applicant's request for a limited waiver of the Public Utility Holding Companies and Affiliated Interests Rules does not sufficiently mitigate potential harm to ratepayers in Arizona. Staff finds that public interest is better served by conditionally authorizing Level 3 Arizona to guarantee, and to the extent necessary, to encumber its Arizona assets as security for the proposed debt financing. A.R.S. §40-285 requires public service corporations to obtain Commission authorization to encumber certain utility assets. The statute serves to protect captive customers from a utility's act to dispose of any of its assets that are necessary for the provision of service, thus, it serves to preempt any service impairment due to disposal of assets essential for providing service. In this instance, a pledge of the Applicant's assets should not impair the availability of service to customers since it provides competitive services that are available from alternate service providers. However, customers may still have exposure to losses to the extent they have prepaid for service or made deposits. Accordingly, any authorization for encumbrances should provide customer protection for prepayments and deposits.

Consumer Services Issues

Corporations Division of the Arizona Corporation Commission reports that Level 3 Arizona was in good standing.

Staff's search of the Consumer Services database indicates that the Applicant had zero complaints, inquiries and opinions from January 1, 2003 to December 26, 2006.

Staff Conclusions and Recommendations

Staff concludes that the proposed pledge of Arizona assets by Level 3 Arizona should not further impair its financial status, further hinder its ability to attract capital at fair and reasonable terms or inhibit its ability to provide safe, reasonable and adequate service. However, customers may still have exposure to losses to the extent they have prepaid for service or made deposits.

Staff recommends approval for Level 3 Arizona to issue guarantees and pledge its Arizona assets as security for Level 3 Financing, Inc.'s proposed Notes, in an amount up to approximately \$1.5 billion, subject to the conditions that all Arizona customer deposits and prepayments, if any, be excluded from encumbrance, or in the alternative, be secured by a bond or an irrevocable sight draft letter of credit which is not included in the pledged collateral.

Staff recommends that if Level 3 Arizona exercises the option of procuring a performance bond to protect Arizona customer deposits and prepayments, that it files proof of the performance bond in Docket Control, within 60 days of the effective date of the decision in this proceeding.

Staff further recommends authorizing the Applicants to engage in any transactions and to execute or cause to be executed any documents so as to effectuate the authorizations requested with the application.

THE ARIZONA REPUBLIC

PUBLIC NOTICE OF FILING of LEVEL 3 COMMUNICATIONS, LLC for APPROVAL of WAIVER of PUBLIC UTILITY HOLDING COMPANIES and AFFILIATED INTEREST RULES and ENCUMBRANCE OF ASSETS
 Docket No. T-03654A-06-0689
 Level 3 Communications, LLC ("Level 3 LLC") filed an application with the Arizona Corporation Commission ("Commission") on October 25, 2006, requesting a limited waiver of the Commission's Public Utility Holding Companies and Affiliated Interests Rules, A.A.C. R14-2-801 to R14-2-806 (the "Rules"), in connection with certain financing arrangements. Specifically, Level 3 LLC seeks a waiver of the Rules to allow it to guarantee up to \$1.5 billion in notes to be issued by Level 3 Financing, Inc. to qualified institutional buyers. In the alternative, Level 3 LLC requests Commission approval of its guarantee pursuant to the Rules. In addition, Level 3 LLC seeks approval of any encumbrance of its assets that may be necessary to secure the financing arrangements.
 The Application is available for inspection during regular business hours at the offices of the Commission located at 1200 West Washington Street, Phoenix, Arizona 85007; and at the office of Level 3 LLC's legal counsel, Lewis and Roca LLP, 40 North Central Avenue, Suite 1900, Phoenix, Arizona 85004. The Commission may grant the Application without a hearing.
 If you have any questions concerning this Application, have objections to its approval, or want information on intervention, you may contact the Consumer Services Section of the Commission at 1200 West Washington Street, Phoenix, Arizona 85007, or call 1-800-222-7000. The Commission does not discriminate on the basis of disability in admission to its public meetings. Persons with a disability may request a reasonable accommodation such as a sign language interpreter, as well as request this document in an alternative format, by contacting Linda Hogan, ADA Coordinator, voice phone number 602-542-3931, e-mail LHogan@cc.state.az.us. Requests should be made as early as possible to allow time to arrange the accommodation.
 Published: November 30, 2006

STATE OF ARIZONA
 COUNTY OF MARICOPA } ss.

Karen Way, being first duly sworn, upon oath deposes and says: That she is a legal advertising representative of the Arizona Business Gazette, a newspaper of general circulation in the county of Maricopa, State of Arizona, published at Phoenix, Arizona, by Phoenix Newspapers Inc., which also publishes The Arizona Republic, and that the copy hereto attached is a true copy of the advertisement published in the said paper on the dates as indicated.

The Arizona Republic

November 30, 2006

Karen Way

Sworn to before me this
 1ST day of
 December A.D. 2006



Marilyn Greenwood
 Notary Public